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OFFICE OF THE  
EXECUTIVE SECRETARY



**EDISON ELECTRIC  
INSTITUTE**

*Via overnight delivery*

June 11, 1999

Mr. David Waddell  
Executive Secretary  
Tennessee Regulatory Authority  
460 James Robertson Parkway  
Nashville, TN 37243-0505

Re: Docket No. 98-00690

Dear Mr. Waddell:

Enclosed for filing in the above-referenced docket are the original and thirteen copies of the Reply Comments of the Edison Electric Institute. Thank you for your attention in this matter.

Sincerely,

A handwritten signature in cursive script, reading "Johannes W. Williams".

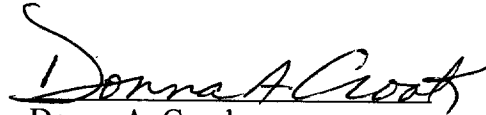
Johannes W. Williams

Director, Industry Legal Affairs  
Enclosures

cc: Service List (w/ enclosure)  
Mathew J. Morey, Ph.D., EEI  
Julia M. Valliere, EEI

**PROOF OF SERVICE**

I, Donna Crook, do hereby certify that copies of the foregoing Reply Comments of the Edison Electric Institute were sent, this 11<sup>th</sup> day of June, 1999, via next day delivery, to all individuals listed on the attached service list.

A handwritten signature in black ink, appearing to read "Donna A. Crook", written over a horizontal line.

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Tennessee Regulatory Authority  
Service List  
Docket No. 98-00690

BEFORE THE  
TENNESSEE REGULATORY AUTHORITY

REC'D TN  
REGULATORY AUTH.

In the Matter of the Notice to Amend the  
Tennessee Administrative Code Part 1220

99 JUN 14 AM 11 54  
Docket No. 98-00690

REPLY COMMENTS OF THE EDISON ELECTRIC INSTITUTE

OFFICE OF THE  
EXECUTIVE SECRETARY

I. Introduction

Pursuant to the Notice of Rulemaking Hearing published by the Tennessee Regulatory Authority ("Authority") in the Tennessee Administrative Register and the correspondence from Kingsport Power Company ("Kingsport") to the Consumer Advocate Division ("CAD") and the Executive Director of the Authority of April 12, 1999 and April 14, 1999, respectively, the Edison Electric Institute ("EEI") hereby respectfully submits the following comments that reply to the initial comments filed by Kingsport and the CAD. EEI filed timely opening comments on May 21, 1999. EEI urges the Authority to not adopt the guidelines for cost allocations and affiliate transactions as proposed because:

- 1) Sufficient regulatory and market protections are in place to protect ratepayers from possible cross-subsidization and cost-shifting activities between the regulated utility and its non-regulated affiliates;
  - 2) Specific provisions of the proposed guidelines go far beyond what is necessary to achieve the goal of protecting consumers and are inconsistent with industry standards;
  - 3) Adoption of guidelines would be premature at this time, as the "Guidelines for Cost Allocation and Affiliate Transactions" currently under consideration by the National Association of Regulatory Utility Commissioners ("NARUC"), upon which the guidelines proposed in this proceeding are based, have not been adopted.
- II. The Proposed Guidelines Are Unnecessary and Excessive and Are Based on a Pending Regulatory Proposal, Not A Final NARUC Resolution
- A. Current Regulatory and Market Protections Effectively Prevent Cross-Subsidization and Cost-Shifting

The CAD argues that certain transactions between a regulated utility and its non-regulated affiliate, unless prohibited, may ultimately harm consumers of regulated services through a virtual plethora of improper cost-shifting, cross-subsidization and the circumvention of regulation. The CAD specifically refers to (i) non-structurally separated divisions providing non-regulated services and (ii) transactions between the utility and its non-regulated affiliates. CAD Comments at 2. Also, the CAD states that, lacking proper "supervision," utilities will potentially pass costs which should be born by non-regulated operations onto captive ratepayers. Finally, the CAD argues that the potential cost-shifting activities of regulated utilities may erode competition in both regulated and non-regulated markets. The CAD's ambitious and expansive arguments ignore current and effective regulatory oversight that routinely governs the costs that are recovered in rates as well as market protections and other basic competitive considerations.

1. Improper Cost-Shifting and Cross-Subsidization

For as long as EEI has taken a position on this issue, we have steadfastly opposed utility subsidization of non-regulated activities by regulated ratepayers. This has been the ironclad EEI position in all state regulatory proceedings in which EEI has participated. E.g., Comments to the California Public Utilities Commission on the October 31, 1997 Draft Decision of ALJ Econome and the Alternate of Commissioners Knight and Bilas and "California Standards of Conduct" by Dr. Alfred E. Kahn, Docket No. R.97-04-011 (November 17, 1997)(and in the initial and reply comments of EEI in the same proceeding, filed July 30, 1997 and August 14, 1997, respectively); Rebuttal Testimony of Dr. Mark Newton Lowry, Illinois Commerce Commission Docket Nos. 98-0147 and 98-0148 (November 13, 1998); Comments to the Maine Attorney General on Vertical Market Power Issues (November 6, 1998). Exploitation of economies of scope, scale

and integration that result in lower costs of providing both regulated and non-regulated services in no way constitute cost-shifting or cross-subsidization.

Cross-subsidization occurs whenever a firm that produces more than one product uses the revenues from the sale of one product to reduce the costs of producing another product that it is selling at a price below its incremental production cost.<sup>1</sup> If the price of the product sold at a loss is below the "incremental" cost of its production and the price of the other product covers all other joint production costs, the firm is cross-subsidizing the first product. For example, when there are two products jointly produced, the incremental revenue from the sale of the first must be at least as great as the incremental cost of producing it and the same must be true for the second product. Obviously, any single-product firm that sells its product at a price below the costs of production will not survive. However, a multi-product firm could sell one product at a price below its incremental cost and make up the losses by charging more for another of its products, depending on how sensitive consumers are to prices charged for the subsidizing product.

A cross-subsidy exists when a service or product is sold below its incremental cost or when consumers of other services or products produced by the same firm could be made better off (i.e., pay lower prices for those other products) if the firm did not produce the service or product. The CAD argues that, unless onerous transfer pricing rules are in place, non-regulated affiliates could "shift" their costs to the regulated utility's customers and recover them in rates.

CAD Comments at 8-10. This cost shifting could occur, for example, through regulated

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<sup>1</sup> Kahn, Dr. Alfred E., Letting Go: Deregulating the Process of Deregulation at 82-89 ("Considerations of pure economic efficiency would require that ... transfers be at bare marginal or incremental costs" (at 87)) (Michigan State University Public Utilities Papers 1998); see also EEI Economics Department, The Truth about the HVACR Industry: Why Utility Affiliate Participation is Good for Consumers, at 13 (September 1998).

distribution service due to its monopoly status.

Consumers' welfare can be lowered when the utility and its non-regulated affiliate engage in transfer prices that subsidize the affiliate through either "self-dealing" or "cost-shifting."

"Self-dealing" might occur if the transfer price for a transaction between the utility and its affiliate is set internally and either is not directly governed by market forces or governed by reasonable regulatory rules. "Cost-shifting" would occur if the utility can shift costs appropriately associated with the non-regulated, competitive side of the business to the regulated, monopoly side of the business where it can recover them from consumers whose demand is likely to be less sensitive to increases in prices. The proposed guidelines are, however, unnecessary in light of existing protections to prevent cost-shifting or cross-subsidization.

## 2. Regulatory Protections

Non-regulated business operations are not new to the electric industry. Most electric utilities throughout the nation provide both regulated and non-regulated products and services and have been doing so for years. Non-regulated activities can be performed either as part of a utility company (with below-the-line income and expenses) or through non-regulated affiliates or other affiliated or subsidiary companies.

The only electric utility to submit comments in this proceeding was Kingsport, a subsidiary of the American Electric Power Company, Inc. ("AEP") system. As a part of a registered holding company, Kingsport is subject to many local, state and Securities and Exchange Commission ("SEC") regulations as to conditions of service, operating procedures, accounting procedures and the determination of rates for its services. A registered holding company such as AEP and its subsidiary company, Kingsport, must conduct business in conformity with the Public Utility

Holding Company Act of 1935 as administered by the SEC. AEP is under the SEC's extensive jurisdiction for accounting, auditing, and reporting purposes. For regulatory purposes, Kingsport falls under the jurisdiction of the Authority.<sup>2</sup>

Existing regulatory accounting, transfer pricing rules, audits and access to books and records of the regulated utility as prescribed by SEC (in the case of Kingsport) all provide more than adequate regulatory protection and detection capability. State regulators such as the Authority have developed expertise at safeguarding ratepayers through cost accounting practices that render the proposed guidelines redundant and unnecessarily costly.

3. Market Protections

In its initial comments, Kingsport points out that CAD's solution to concerns regarding potential subsidization of non-regulated affiliates by regulated utilities through adoption of asymmetrical pricing is unnecessary, counterproductive and fundamentally devoid of any sound economic principle. Kingsport Revised Comments at 11. EEI agrees with Kingsport. As we stated in our initial comments at 9, although asymmetric pricing rules may protect consumers of regulated services from cross-subsidization, they also strongly discourage transactions between the utility and its unregulated affiliate that could otherwise reduce the costs of regulated and unregulated operations.

B. Specific Provisions of the Proposed Guidelines Are Excessive and Inconsistent with Industry Standards

The CAD mistakenly relies on proposed language originally labeled "Audit Requirements" from an October 1998 draft of "Guidelines for Cost Allocation and Affiliate Transactions" under

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<sup>2</sup> Two other investor-owned utilities are subject to regulation by the Authority, one of which is a registered holding company.



consideration by various NARUC committees. CAD Comments at 12. NARUC's Staff Subcommittee on Accounts ("SSA") has since amended the guidelines considerably and further revisions are likely before expected final action on the SSA's proposal at the NARUC summer committee meetings next month.

The CAD promotes the language that, in part, allows the Authority complete access to all affiliate books and records. Further, the CAD states that, without such access, the Authority would be "unable to carry out its responsibilities of determining that costs included in utility rates are just and reasonable." CAD Comments at 12. This statement is misleading and misrepresentative of the need for open access to affiliate books and records and attendant audit functions that comply with regulatory oversight requirements.

Standard accounting practice emphasizes the importance of audit trails to follow the flow of a transaction from beginning to end. Precise policies and practices exist within regulated utilities to ensure the integrity of the transactional audit trail. An audit trail should exist for all transactions a utility performs, and regulators should have access to those transactions between the regulated utility and the non-regulated affiliate that relate to jurisdictional services and products to ensure that cross-subsidization does not occur. Audits of these specific transactions would reveal any inappropriate cost-shifting or cross-subsidization. However, a partial lack of access to a non-regulated affiliate's books and records does not preclude the Authority or the CAD from carrying out its responsibilities to regulated customers because of the sufficiency of audits conducted by other regulatory authorities. Competitive market services and products provided by non-regulated utilities, which are not relevant to the regulated business or ratemaking activities, should not be open to non-jurisdictional regulatory review.

The books and records of a regulated utility are already subject to intense scrutiny by state and federal regulators and by both internal and external auditors. Depending on the established scope of the audit and jurisdiction of the entity requesting an audit, at least a portion of the books and records of appropriate non-regulated affiliates may also be closely scrutinized, depending on the requirements of state law.

Many levels of audit exist. On the organizational level, the internal audit function of a company is part of a company's control structure. A regulated utility's internal auditing department entails constant monitoring and testing of policies, procedures and controls to ensure compliance with the company's accounting and auditing practices to assure compliance with state and federal requirements, precisely, in part, to ensure that costs recorded on the books can be substantiated and evaluated for prudence in rate cases. The internal audit function of a company may provide significant evidence to external or independent auditors regarding areas of controls examined. A control structure consists of any policies and procedures established to provide a reasonable assurance that the utility's objectives are achieved, for example, to comply with internally established cost allocation and transfer pricing procedures. Other essential control structures involve accounting systems that consist of methods and records established to identify, analyze, classify and assemble transactions. Utility control structures are tested in any audit with the independent auditor's opinion.

Independent audits are also required at the state and federal level. Financial audits in which an independent auditor renders an opinion on the accuracy of the utility's financial statements as prepared by management have well established procedures. An independent attestation report can address examination of, for example, transactions and systems and agreed-

upon procedures or a combination of both. While financial information can be a part of such a report, the audit can also attest to assertions from management as to the company's compliance with applicable laws and regulations or the effectiveness of an entity's internal control structure.

The industry standard pertaining to the non-regulated affiliate provides for accounting by category or class. The CAD proposed to force accounting by each product or service. In addition to abandoning the industry standard, the proposal unnecessarily increases the costs and burden to both the regulated entity and the non-regulated affiliate by requiring a significantly more detailed basic accounting unit than is required by standard industry practice. The proposal is unjustified and has the effect of increasing costs to the regulated entity without materially increasing the amount of useful information provided. Presumably, the regulated entity would be allowed to recover these costs in rates.

C. Adoption of Any Guidelines, Especially the Guidelines as Proposed, Is Premature

The CAD correctly stated that NARUC passed a resolution on March 3, 1998 directing the NARUC SSA, together with other staff subcommittees, to prepare for consideration "Guidelines for Energy Cost Allocation." However, the CAD misrepresents the process by alleging that draft "Guidelines for Cost Allocation and Affiliate Transactions" ("Guidelines") were subsequently adopted by either the NARUC itself or even the SSA. The draft Guidelines are still, in fact, a draft with ongoing, active debate in which EEI is an interested participant. Furthermore, the SSA issued a revised draft of the guidelines on April 6, 1999 (not referenced by the CAD), at the direction of select Commissioners designated at the February 1999 NARUC committee meetings to resolve the contested issues. EEI provided extensive substantive comments to the SSA regarding the revised Guidelines on April 30, 1999 in a joint filing with the American Gas

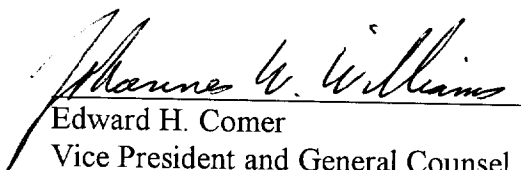
Association. Additionally, a meeting is scheduled for June 25, 1999 "to attempt to craft a consensus resolution" on the outstanding issues relating to the Guidelines and present that resolution at the NARUC summer committee meetings.<sup>3</sup> As a result, still further drafts of the Guidelines will likely be forthcoming from the SSA for formal consideration by Commissioners at the upcoming NARUC meetings in July. Therefore, at this time it is virtually certain that NARUC will not adopt the Guidelines in the form in which they existed at the time relied upon by the CAD, i.e., October 1998.

### III. Conclusion

Based on the foregoing, the Authority should not adopt the guidelines for cost allocation and affiliate transactions as proposed.

Date: June 11, 1999

Respectfully submitted,



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<sup>3</sup> Memo from Florida Public Service Commission Commissioner J. Terry Deason to Virginia State Corporation Commission Commissioner Hullihen Moore and Kentucky Public Service Commission Commissioner Edward Holmes et al. regarding NARUC Guidelines for Cost Allocation and Affiliate Transactions (June 8, 1999).